Beyond Enron: Regulation in Energy Derivatives Trading

Alexia Brunet
Meredith Shafe

Follow this and additional works at: http://scholarlycommons.law.northwestern.edu/njilb
Part of the Energy Law Commons, International Law Commons, International Trade Commons, and the Securities Law Commons

Recommended Citation
Beyond Enron: Regulation in Energy Derivatives Trading

Alexia Brunet* & Meredith Shafe**

I. INTRODUCTION

The bankruptcy of the Enron Corporation in December 2002 is the biggest corporate bankruptcy in U.S. history.1 The Houston-based company, formed in 1985, became the nation’s seventh-largest company in revenue by buying electricity from generators and selling it to consumers.2 Because Enron made the market3 in energy trading, its collapse fundamentally altered the U.S. energy trading industry. Equally important, the disclosure of Enron’s role in California’s power market crisis shattered confidence in deregulated wholesale-electricity and natural gas markets, creating obstacles for new players seeking to restore confidence in energy trading markets.4 New market entrants offer their clients a more complete contracting environment, self-regulate with more transparent risk

* Alexia Brunet, J.D., Ph.D. is a Visiting Assistant Professor of Law, Northwestern University School of Law and Special Counsel, U.S. Department of Homeland Security. She is the contacting author: a-brunet@law.northwestern.edu.

** Meredith Shafe, J.D., is an associate at Chapman and Cutler LLP and a 2006 graduate of Northwestern University School of Law.

1 See CNN.com, Explaining the Enron Bankruptcy, (Jan. 13, 2002) available at http://archives.cnn.com/2002/US/01/12/enron.qanda.focus/ (noting that its stock, worth more than $80 about a year ago, has tumbled to less than $1 per share. Enron’s collapse left investors burned and thousands of employees out of work with lost retirement savings).

2 Id.

3 To “make a market” means “to be ready, willing and able to buy or sell a particular security as a dealer. The individual who does this is called a specialist, if the security is listed, or a market maker, if the security is traded over-the-counter.” Investorwords.com, Make a Market, http://www.investorwords.com/2924/make_a_market.html (last visited Mar. 28, 2007).

management policies, and face more investigative and prosecution efforts by the Federal Energy Regulatory Commission ("FERC") and the Commodity Futures Trading Commission ("CFTC"). Nevertheless, the imprint of Enron's demise continues to haunt energy markets and energy-related derivatives.6

In this article we recount the development of energy derivative trading markets in the United States, Enron's role in the industry's development, and the ways in which Enron's demise and the surrounding events influenced the structure and regulation of energy trading.7 If not for the furor and suspicions raised by Enron, particularly surrounding the California energy crisis, legislative proposals currently in Congress that seek to limit the role of energy derivatives would have seemed unlikely, if not illogical, when first introduced.8

Today, energy-related derivatives are a multi-billion dollar market9 and an important means of transferring financial risks associated with price volatility inherent in commodity markets.10 Derivatives are contracts or securities that derive their value from the price of an underlying risk factor or asset, such as the price of a commodity or Treasury bond.11 By using derivatives, the risk in any given contract can be separated into manageable pieces and spread among others capable of absorbing it.12 Market participants trade in derivatives either to hedge a risk to which their income

---


6 See Smith, supra note 4, at C1.

7 For purposes of this paper, "regulation" of energy trading will be limited to federal legislation and agency regulation of energy trading—i.e., energy futures and options contracts and over-the-counter energy derivative contracts.

8 See Smith, supra note 4, at C1.


Beyond Enron

is exposed or to speculate in changes in energy market conditions.\textsuperscript{13} When trades use derivatives as risk management mechanisms, they do so to eliminate exposures to the energy market fluctuation.

Energy-related derivatives were developed long before the collapse of Enron, in response to price volatility caused by economic conditions and deregulation in the energy industry. A key feature to note is that energy demand is price inelastic, meaning that demand for energy is not very responsive to price. Beginning with the OPEC oil embargo and subsequent oil shortages in the 1970s, energy price volatility took on new dimensions from a more stable regime that dominated the market since World War II.\textsuperscript{14}

In addition to the oil shocks, the deregulation of natural gas and electricity markets in the United States beginning in the 1980s added more volatility as prices were allowed to fluctuate with economic conditions rather than be fixed by a regulator.\textsuperscript{15} Although evidence suggests that deregulation made the wholesale energy markets for natural gas and power become more competitive in this period, price volatility greatly affected retail utility suppliers, industrial clients, and energy companies themselves. Energy derivatives emerged as a method for energy buyers to offload some of the risk of the price volatility.

The newly deregulated, newly volatile energy industry followed the example of the banking industry, which had already developed financial derivatives to hedge against interest rate and currency exchange fluctuations. Derivatives had revolutionized banking, providing the ability to offload risk and quantify costs with a high degree of certainty.\textsuperscript{16} Energy users hoped that the same could be achieved in the new energy markets. The CFTC oversees the enforcement of exchange rules, conducts surveillance of trading in commodities futures and related cash markets,\textsuperscript{17} and is the authority for regulated derivatives in the nation.\textsuperscript{18} With CFTC

\textsuperscript{13} See Karol, supra note 11, at 196–98.

\textsuperscript{14} See PHILIP K. VERLEGER, JR., ADJUSTING TO VOLATILE ENERGY PRICES 129 (1993).

\textsuperscript{15} Karol, supra note 11, at 197–98.

\textsuperscript{16} See Greenspan Speech, supra note 12 (noting that relative success of U.S. banks during the recent recession and stating, “better risk management may be the only truly necessary element of success in banking.”); see also President’s Working Group on Fin. Mkts, Over-the-Counter Derivatives Markets and the Commodity Exchange Act, (Nov. 9, 1999), available at http://www.ustreas.gov/press/releases/reports/otcact.pdf [hereinafter PWG Report] (“One of the most dramatic changes in the world of finance during the past fifteen years has been the extraordinary development of the markets for financial derivatives. Over-the-counter derivatives have transformed the world of finance, increasing the range of financial products available to corporations and investors and fostering more precise ways of understanding, quantifying, and managing risk.”).

\textsuperscript{17} See infra, Part II.C.

\textsuperscript{18} Walter L. Lukken & James A Overdahl, Financial Product Fundamentals: A Guide For Lawyers (Practicing Law Institute) § 18:5, The Regulation of Derivative Products (Feb. 2004); see also Andrea S. Kramer, Paul J. Pantano, Jr., & Doron F. Ezickson, Regulation of
approval, energy derivatives developed as a business serving to ensure adequate and efficient supply or energy units at a pre-contracted price. Former Federal Reserve Chairman Alan Greenspan refers to them as indispensable to improved risk management practices and crediting them with the enhanced resilience of financial institutions in the United States.¹⁹

In the energy market, the role of a derivative in risk management, price discovery, and market liquidity functions helps to support and protect vital national services during times of volatility.²⁰

Enron changed all of this. The collapse incited a public outcry against the wild free market of trading, viewed by most casual observers as speculative and manipulative. And yet, the vast depth of demand for energy-related derivative instruments left the market asking for recovery and the public (and thus politicians) demanding oversight. Regulation frameworks have been debated ever since.

This article examines three main themes illustrating how Enron’s collapse relates to features of the current policy environment regulating energy trading. Section II presents the regulation of energy trading contracts and derivatives, CFTC oversight of futures markets and enforcement procedures. Second, Section III discusses the regulatory structure during Enron’s ascent, including discussions of the Commodities Futures Modernization Act of 2000, and Enron’s role in the rise of energy trading. Third, Section IV presents the impact of Enron’s collapse on energy market regulation, introducing the rise of agency investigations and enforcement actions, political responses, and legislation, as well as market responses. Section V discusses present concerns facing the energy trading industry such as the CFTC Reauthorization of 2005, the PUMP ACT, Oil and Gas Traders Oversight Act, as well as recent industry responses to calls for additional natural gas legislation. Section VI provides concluding remarks.

¹⁹ Lukken & Overdahl, supra note 18.

²⁰ This is just a very brief summary of the basic role of derivatives in energy markets. The scope of this paper does not afford a detailed discussion of the economic functions of derivatives in energy markets. For a more in-depth discussion, see Commodities Futures Trading Comm’n, The Economic Purpose of Futures Markets (Feb. 3, 2006), http://www.cftc.gov/opa/brochures/opaeconpurp.htm [hereinafter CFTC Brochure]; Energy Industry Derivatives Report, supra note 10.
II. REGULATING ENERGY TRADING CONTRACTS AND DERIVATIVES

Energy derivatives are financial instruments whose value is linked to the price fluctuation of an energy product.\(^{21}\) In the United States, energy derivative contracts are traded primarily in two markets.\(^{22}\) Derivatives traded on an exchange are called exchange-traded derivatives and contracts entered into through private negotiation are typically called off-exchange or over-the-counter ("OTC") derivatives.\(^{23}\) Contracts traded in each market share similar risk-shifting attributes, but the means by which the contracts are negotiated and the information, liquidity, and counterparty risks can differ.\(^{24}\) These products serve similar economic functions, and are somewhat fungible; however, they are not perfect substitutes and thus they also complement each other.\(^{25}\)

The United States has regulated derivatives trading for many years.\(^{26}\) Regulation varies by the type of derivative product and the parties involved (e.g., a bank, an insurance company, or another regulated entity).\(^{27}\) Energy trading markets include both regulated futures markets and unregulated derivatives markets, and thus, are not governed by a uniform set of trading rules. Moreover, an energy trading transaction can be subject to a particular condition depending on the type of derivative product involved.\(^{28}\) Regulation of energy futures is basically straightforward and settled—trading is conducted on exchanges, such as the NYMEX, subject to exchange rules and CFTC regulation. Futures and options markets (exchange-traded derivatives) are regulated through self-regulation by the exchanges and oversight by the CFTC.\(^{29}\)

---


\(^{22}\) CRS Report, supra note 21, at 1.

\(^{23}\) Id. Futures and options are the most widely-traded derivatives on regulated exchanges.

\(^{24}\) Karol, supra note 11, at 198.

\(^{25}\) Id.


\(^{28}\) For example, aspects of wholesale electricity trading are subject to the overlapping jurisdiction of both the FERC and CFTC. As a result, electricity market participants “face a dizzying array of existing and proposed regulatory requirements.” Kramer et al., supra note 18, at 106–29.

\(^{29}\) See, e.g., Energy Industry Derivatives Report, supra note 10, at 48.
A. Exchange-traded (Regulated) Derivatives

Exchange-traded derivatives are standardized contracts traded through a regulated exchange.\(^{30}\) The New York Mercantile Exchange ("NYMEX") offers futures contracts for crude oil, natural gas, heating oil, and gasoline, and it is the busiest regulated exchange in the country.\(^{31}\) The primary features of contracts offered by exchanges are standardization, a trading platform and a clearing system.\(^{32}\) Standardization ensures that all contracts for a particular commodity and a particular date are the same, and can thus be traded indistinguishably.\(^{33}\) Consequently, futures contracts are traded between parties who never directly negotiate with each other.\(^{34}\) Standardization has some advantages in that the large numbers of market participants trading the same instrument facilitates hedging.\(^{35}\) At the same time, the standardization of futures contracts reduces their merchandising attractiveness in that it cannot be tailored to individual party positions.\(^{36}\)

The trading platform is the mechanism by which buyers and sellers are brought together and orders are matched. A clearinghouse becomes the buyer to the seller and the seller to the buyer, thereby facilitating the process by which parties enter into and exit contracts, and making the contract liquid.\(^{37}\) Moreover, contracting with the clearinghouse protects exchange participants from the credit risk of entering into derivatives contracts directly with another counterparty and assures the financial integrity of the contracts.\(^{38}\)

Commodity futures contracts, such as those traded on the NYMEX, are regulated by the CFTC under the Commodity Exchange Act ("CEA").\(^{39}\) Commodity futures contracts are not explicitly defined in the CEA or CFTC regulations; thus, there has been much discussion about what actually constitutes such a contract. While the CEA requires all trading in commodity futures contracts to comply with CFTC regulations and be conducted only on a designated contract market in accordance with the market rules,\(^{40}\) neither the statute nor the CFTC regulations explicitly define

\(^{30}\) Id.
\(^{31}\) CRS Report, supra note 21, at 1.
\(^{32}\) Energy Industry Derivatives Report, supra note 10, at 47.
\(^{33}\) Id.; see also Karol, supra note 11, 198–99
\(^{34}\) CFTC Brochure, supra note 20.
\(^{35}\) Id.
\(^{36}\) Id.
\(^{37}\) Energy Industry Derivatives Report, supra note 10, at 47.
\(^{38}\) Id.; see also Energy White Paper, supra note 5, at 11–12.
\(^{39}\) Energy White Paper, supra note 5, at 6.
\(^{40}\) See Cargill, Inc. v. Hardin, 452 F.2d 1154, 1156 (8th Cir. 1971) (A commodity “futures contract must be satisfied or liquidated by (1) an opposite and offsetting transaction in the same future prior to the expiration of trading in that future, or by (2) delivery of the specified quantity of [a commodity] by the seller and its receipt and payment by the buyer"
what a commodity futures contract is or what those market rules are. Thus, the CEA allows courts and legislators to determine the limits of the CFTC’s regulatory authority in terms of deciding which contracts fall within the meaning of the statute.

Courts agree that in interpreting the phrase “contracts for sale of a commodity for future delivery,” over which the Commission has regulatory jurisdiction, there is no definitive list of the elements of futures contracts. However, courts abide by the rule that the transaction must be viewed as a whole with a critical eye toward its underlying purpose. Courts recognize certain elements as common to such contracts. For instance, courts have defined commodity futures contracts as agreements for the purchase or sale of a commodity for delivery in the future at a price that is established when the contract is initiated, with both parties to the transaction obligated to fulfill the contract at the specified price, subject to applicable institutional rules such as those of the Chicago Board of Trade. The CFTC has added to these factors, including whether the parties are commercially sophisticated and can bear extra risk, and whether the transaction is structured so that the risk can be magnified before its completion.

\[\text{during the specified delivery month and in conformity with the rules of the Board of Trade.}°\]

\[^{41}\text{The CEA defines the terms “commodity” and “future delivery” but does not define the phrase “contracts for sale of a commodity for future delivery.” Commodity Exchange Act, 7 U.S.C.S. § 1(a) (2006); Elizabeth D. Lauzon, Annotation, What Are Contracts of Sale of a Commodity for Future Delivery Within Meaning of Commodity Exchange Act (7 U.S.C.A. §§ 1 et seq.), 182 A.L.R. FED. 559, 559 (2002).}^{42}\]

\[^{42}\text{See Cargill, Inc., 452 F.2d 1154, at 1154.}^{43}\]


\[^{44}\text{See id. However, courts have noted that as a matter of reality and practice rarely does a commodity futures dealer actually intend to take or make delivery on the commodity. See, e.g., Lauzon, supra note 41, at 576.}^{45}\]

\[^{45}\text{Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg., 39, 188, 39, 191 & n. 10 (Sept. 25, 1990). Characteristics include: (1) if the contract was “entered into for commercial purposes related to the business of a producer, processor, fabricator, refiner or merchantiser who may wish to purchase or sell a commodity for deferred shipment or delivery in connection with the conduct of its business;” (2) if the contract was entered into “to shift future price risks incident to commercial operations and other forward commitments;” (3) if the counterparties “have the capacity to make or take delivery;” (4) if the contract was an “individually and privately negotiated principal-to-principal transaction[]”; (5) if the contract could not be assigned “without the consent of the parties,}°\]
B. Over-the-Counter Markets

Since the explosion of energy derivatives products over the past few years, over-the-counter ("OTC") trading, or activity that does not take place on an exchange,\(^46\) accounts for the majority of the energy trading industry.\(^47\) In contrast to the standardized terms and regulated environment of exchange-traded derivatives, OTC derivatives are not standardized—they are essentially contracts between two parties, the terms of which vary based on party demands.\(^48\) For example, some sophisticated traders create hybrid instruments to take advantage of particular trading opportunities.\(^49\) There are benefits to negotiating contract terms in that parties can reduce risk by assuring that the terms of the derivative contract more closely match the characteristics of their physical market positions. However, the advantage of customization comes at the expense of the liquidity and credit assurances offered by exchange-traded derivatives.\(^50\)

OTC trading takes place largely on electronic exchanges such as the Intercontinental Exchange (ICE). In the OTC market, firms act as dealers, trading individually negotiated derivatives contracts with other market participants, such as banks, hedge funds, and energy companies, all in an effort to reduce their risk exposure to energy prices.\(^51\) The flexibility allowed in these markets has led to a large volume of daily trades between parties.\(^52\) However, in OTC transactions that are not cleared, each party to the transaction assumes the risk that their counterparty will be in a financial condition to execute the contract on the date of expiration—i.e., credit

---

\(^{46}\) See PWG Report, supra note 16.

\(^{47}\) See PWG Report, supra note 16.

\(^{48}\) See PWG Report, supra note 16.

\(^{49}\) See PWG Report, supra note 16.

\(^{50}\) CRS Report, supra note 21, at 2. Technically, over-the-counter derivatives can be entered into between any two counter-parties. In practice however, the market has come to be structured as a dealer market.

\(^{51}\) Id. Swaps are always traded over-the-counter, as are all exotic derivatives. Options are traded over-the-counter as well as on exchanges, usually depending on the nature of the underlying commodity. Also, most natural-gas trading occurs over-the-counter.
In contrast, by trading on an exchange, which screens the quality of market participants, futures traders are free to transact without this concern. This concern was brought to the forefront of the industry after the failure of Enron and other major trading parties. As a result, new electronic trading markets provide clearing services to OTC trading parties.54

The OTC market differs from conventional markets in that it combines a wide array of transactions and customized products without any unifying characteristics or regulatory structure.55 As such, depending on the product and on how the transaction is settled, multiple types and levels of regulation may apply to OTC derivatives.56

The first regulatory exemption for energy derivatives trading, the CFTC's Energy Order, exempts individually-negotiated derivative transactions between commercial participants in the energy sector that involves crude oil, natural gas liquids and their derivative products.57 Energy derivatives contracts between "eligible participants" (institutional investors, financial institutions, governmental entities, professional traders, and businesses or individuals with more than $10 million in assets) are generally exempt from regulation under the CEA.58 Presumably, public consumers differ from sophisticated parties in that public consumers require investor-protection regulation provided by futures exchanges.59 Nonetheless, the CFTC does retain limited jurisdiction over the OTC markets to enforce the CEA anti-fraud and anti-price manipulation provisions. Furthermore, the CFTC can mandate disclosure of some transaction information (such as price, volume, and delivery intention) from

---

53 See Energy White Paper, supra note 5; Karol, supra note 11, at 204–05.
54 See, e.g., Peter C. Fusaro, The Human Element In Energy Trading, ELEC. PERSPECTIVES, Nov.–Dec. 2002, available at http://www.eei.org/magazine/editorial_content/nonav_stories/2002-11-01-trade.htm ("Many exchanges have begun offering OTC clearing services in an attempt to calm traders' fears, with NYMEX and ICE leading the way in adapting their business models.").
56 Id.; see also PWG Report, supra note 16, at 168 (noting that further complexity results from the significant use of over-the-counter derivatives by entities that are also subject to one or more regulatory regimes, either as intermediaries (e.g., investment banks) or as end users (e.g. pension funds and investment companies)). In addition, there are OTC transactions within the jurisdiction of the CFTC or SEC that are regulated differently than exchange-traded products. Derivatives and Risk Management in Energy Industries, supra note 55, at 49.
57 This exemption applies to transactions between principals and subject to individual negotiation that have no unilateral right of offset. See Energy Order, 58 Fed. Reg. 21286-02 (Apr. 20, 1993).
58 CRS Report, supra note 21, at 2.
59 Id.
those OTC traders who use certain electronic trading systems.\textsuperscript{60}

This decision by the CFTC not to regulate the new OTC energy derivatives markets was an affirmative choice by the regulators and has been reaffirmed in subsequent legislation.\textsuperscript{61} Consequently, for OTC derivatives exempt or excluded from CFTC regulation, the application of a regulatory scheme typically is based on the party that is offering or entering into the contract being a registered entity.\textsuperscript{62} Since the contract or transaction is not regulated, the trading of OTC energy derivatives is referred to as unregulated energy trading.\textsuperscript{63}

The Intercontinental Exchange (ICE) is the most prominent example of such an electronic trading system. ICE operates its OTC electronic platform as an exempt commercial market under the CEA and regulations of the CFTC. The CFTC generally oversees, but does not substantively regulate, the trading of OTC derivative contracts on the ICE platform. As an exempt commercial market, ICE is required to comply with the access, reporting, and record-keeping requirements of the CFTC, but ICE’s OTC business is not otherwise subject to substantive regulation by the CFTC or other U.S. regulatory authorities.\textsuperscript{64} In addition, ICE is required to report to the CFTC certain information regarding transactions in products that are subject to the CFTC’s jurisdiction and that meet certain specified trading volume levels, as well as to record and report to the CFTC complaints of alleged fraud or manipulative trading activity related to certain ICE products that the company receives.\textsuperscript{65}

C. CFTC Oversight of Futures Markets and Enforcement Procedures

Futures markets play a critically important role in the U.S. economy. They provide risk management tools that producers, distributors, and

\textsuperscript{60}See, e.g., id.

\textsuperscript{61}See, e.g., PWG Report, supra note 16; Christoph Faille, \textit{Why the Case For a Free Market in Energy Derivatives Has Survived Enron}, 50 Fed. Law. 39, 43 (2003). The Commodities Futures Modernization Act of 2000 will be discussed \textit{infra} pp. 13–15. Moreover, CFTC Commissioners have repeatedly stated in public statements that the CTFC will not regulate OTC trading like it regulates non-exempt derivatives trading.

\textsuperscript{62}Energy Industry Derivatives Report, supra note 10 ("OTC derivatives may fall into one of four general regulatory jurisdictions—CFTC, SEC, a banking regulator, or an insurance regulator—or none at all.").


\textsuperscript{64}See Intercontinental Exchange, ICE: The Energy Marketplace, https://www.theice.com/profile.jhtml (last visited Mar. 28, 2007). Both the CFTC and FERC have view-only access to the ICE trading screens on a real-time basis.

\textsuperscript{65}Id.
commercial users of commodities use to manage price risk. The futures markets also play a price discovery role, as participants in related cash and OTC markets look to futures markets to discover prices that accurately reflect information on supply, demand, and other factors. Since 2000, the CFTC has exercised regulatory authority over commodity futures contracts and options, including futures and options on "exempted" securities, such as Treasury bills traded on CFTC-approved exchanges and in the OTC market. The CFTC is also responsible for regulating all exchanges that trade commodities for future delivery, approving all futures and options contracts traded on these exchanges, registering traders who buy or sell commodities for others, and monitoring exchange information such as volume and open interest. While the CFTC does not have regulatory authority over exempted derivatives and transactions conducted over-the-counter between specified entities, the Commission investigates energy trading that impacts the futures markets under its anti-fraud and manipulation authority.

To illustrate the CFTC's role in overseeing exchange rules and enforcing the CEA's anti-fraud and market manipulation rules, this section will briefly describe the CFTC's current market oversight and enforcement procedures for exchange-based energy futures trading. The CFTC operates a comprehensive system of collecting information on market participants. The Commission collects market data and position information from exchanges, clearing members, futures commission merchants, foreign brokers, and traders. The Large Trader Reporting System (LTRS) requires traders to file daily reports and is the cornerstone of the CFTC's market surveillance program. Under LTRS, clearing members, FCMs, and

---

66 For instance, the Chicago Board of Trade trades derivatives that guarantee the future delivery of corn. Anyone needing a few thousand bushels in the months to come can lock in the price today. CFTC Brochure, supra note 20.


68 Id.; cf Michael Schroeder, Futures Traders Resist Tighter Oversight Plan – Bill Would Give Commodity Commission Greater Regulatory Powers Over Some Gas Markets, The WALL ST. J., Feb. 10, 2006, at A6 (discussing recent debates over the scope and extent of the CFTC's authority to investigate and regulate trading activities in over-the-counter markets, and quoting a CFTC director, who notes that the over-the-counter and futures markets are interdependent and thus, investigations into the futures markets have involved over-the-counter transactions as well).

foreign brokers (reporting firms) file daily reports which show the futures and option positions of traders that hold positions at or above specific reporting levels set by the CFTC. The CFTC may review the terms and conditions of a contract to determine whether it is not readily susceptible to manipulation. Once listed, CFTC staff closely monitors, on a real-time basis, trading on the exchanges to detect unusual activity or price aberrations that may indicate actual or attempted manipulation. Through this system, the CFTC becomes aware of concentrated and coordinated positions that might be used by one or more traders to attempt market manipulations. In addition, each futures exchange is required under the CEA to supervise trading, prices, and positions and must impose trade position limits, where appropriate, to guard against manipulation; reporting firms are subject to on-site audits by exchange and Commission staff.

Upon identifying a potential threat, the CFTC consults and coordinates its activities with the regulatory staff of the exchange(s). The Commission may require a firm to file additional trading reports and may make a “special call” on a firm to provide more information about its trading. On a special call CFTC staff may contact, for example, the largest long- and short-side traders, to obtain information on their delivery intentions and capability and their price objectives in liquidating trades, to advise them of the CFTC’s concern regarding the orderly expiration of the futures contract. This procedure is usually effective in resolving most potential disputes. On four historic occasions, the CFTC exercised its emergency powers to limit, liquidate, or halt trading.

III. THE REGULATORY STRUCTURE DURING ENRON’S ASCENT

OTC markets have expanded the types of derivatives contracts

---

70 From time to time, the Commission may raise or lower these reporting thresholds in specific markets, “to strike a balance between collecting sufficient information to oversee the markets and minimizing the reporting burden on the futures industry and the public.” Id.

71 In addition to the CFTC’s oversight programs, designated contract markets, derivatives transaction execution facilities, and designated clearing organizations also have self-regulatory responsibilities. Designated contract markets must meet eighteen core principles on an ongoing basis, derivatives transaction execution facilities must comply with nine core principles, and DCOs must comply with fourteen core principles. Id.

72 Commodity Futures Trading Comm’n, The CFTC’s Large-Trader Reporting System, supra note 69. The Commission has assigned confidential reporting numbers to reporting firms and traders to ensure the privacy of the information they provide. Except under limited circumstances, the Commission is prohibited (under § 8 of the CEA) from publicly disclosing any person’s positions, transactions, or trade secrets.

available to energy market participants beyond simple futures contracts and include many new types of derivatives unregulated by the CFTC.74

Throughout the 1990s, as derivatives developed increasingly innovative and complex contract structures, market participants faced uncertainty about the legal status of OTC derivatives trading and unregulated energy derivatives. By the late 1990s, this legal uncertainty hindered further development of derivatives trading in energy markets. Calls for legal clarity and market events prompted Congressional efforts to clarify the CFTC’s jurisdiction and overhaul the existing regulation scheme for OTC derivatives.75 Congress enacted the Commodity Futures Modernization Act of 2000 (“CFMA”), the most significant “pre-Enron” energy trading legislation, to overhaul the provisions of the CEA.76 The most significant “post-Enron” energy-trading legislation—the CFTC Reauthorization—will be discussed in the context of current issues in the energy trading industry.

A. The Commodities Futures Modernization Act of 2000

The CFMA emerged to resolve uncertainty concerning the legal status and enforceability of OTC derivatives transactions.77 Many industry participants feared that without clarification of the CFTC’s jurisdiction, a court ruling that OTC derivatives were “futures contracts” could derail the burgeoning market.78 With passage of the Act, Congress sought to confirm the CFTC’s jurisdiction over futures contracts.79 Congress relied heavily on a “policy roadmap” provided by the President’s Working Group on Financial Markets (“PWG”) in its November 1999 report “Over-the-

---

74 See Jerry W. Markham, The Birth of the Unregulated Derivatives, in COMMODITIES REGULATION: FRAUD, MANIPULATION & OTHER CLAIMS, 13A COMMODITIES REG. § 27:31 (Clark Boardman Callahan 2005) (discussing the development of hybrid and exotic derivatives and other derivatives instruments that were not “contracts for sale of a commodity for future delivery” under the CEA).

75 In late 1998, the near-collapse of hedge fund Long-Term Capital Management prompted the then-chairwoman of the CFTC to suggest that the agency should consider some regulation of derivatives contracts. Schroeder, supra note 68.


79 See Commodities Futures Trading Comm’n, About the CFTC, http://www.cftc.gov/ant/anrabout00.htm (Feb. 6, 2006) [hereinafter About the CFTC].
Counter Derivatives and the Commodity Exchange Act” which clarified the CFTC’s jurisdiction in the OTC market. In determining the CFTC’s authority, the report looked to whether the products were being traded by retail customers, whether the products were susceptible to price manipulation, and whether the participants were not otherwise regulated. Absent these factors in the market, the PWG found no policy justification for CFTC oversight. Consequently, the report concluded that OTC derivatives transactions should be subject to the CEA only if necessary to achieve the public policy objectives of the act—deterring market manipulation and protecting investors against fraud and other unfair practices.

In the case of financial derivatives transactions involving professional counterparties, the PWG concluded that regulation was unnecessary for these purposes because financial derivatives generally are not readily susceptible to manipulation and because professional counterparties can protect themselves against fraud and unfair practices. As such, the PWG recommended that financial OTC derivatives transactions between professional counterparties be excluded from coverage of the CEA, even if executed electronically.

Finally, to further facilitate the development of efficient and reliable electronic trading systems, the PWG recommended that transactions otherwise excluded from the CEA not fall within the ambit of the act simply because they are cleared. The PWG concluded that clearing should be subject to government oversight but that such oversight need not be provided by the CFTC. Instead, the PWG suggested that for many types of derivatives, oversight could be provided by the SEC, the Office of the Comptroller of the Currency, the Federal Reserve, or a foreign financial regulator that the appropriate U.S. regulator determines to have satisfied its standards.

As enacted, the CFMA incorporated most of the PWG’s recommended provisions, streamlining regulation of futures and derivatives markets and providing crucial legal certainty for OTC derivatives. Moreover, in recognition of the rapidly changing derivatives market, the CFMA replaced the CEA’s prescriptive rules and regulations with a “principles-based approach,” to provide flexibility for market participants to

---

80 Id. (“The provisions of [the Senate’s CFMA bill] that address OTC derivatives are generally consistent with the PWG’s conclusions and recommendations.”).
81 PWG Report, supra note 16, at 22.
82 Id.
83 Id.
84 Id.
85 Id.
86 Lukken, supra note 78.
use best practices to comply with statutory requirements.\textsuperscript{87} Most relevantly, the CFMA provided the regulatory infrastructure for energy derivatives trading markets to flourish. First, it provided legal certainty for OTC products by exempting all OTC transactions involving energy commodities derivatives from most regulatory requirements of the CEA.\textsuperscript{88} Second, the CFMA facilitated the innovation of electronic trading systems for OTC derivatives products by creating a new category of trading facility called the exempt commercial market and permitting the clearing of OTC transactions.\textsuperscript{89} Together, these changes increased innovation and competition in trading markets for energy futures and OTC derivatives.\textsuperscript{90}

The CFMA provided the legal infrastructure for the heyday of the energy trading business, led by Enron. The booming growth of energy trading markets that followed in 2000 and 2001 appeared to confirm the enactment of the CFMA of 2000 as a regulatory success.\textsuperscript{91}

B. Enron’s Role in the Rise of Energy Trading

Active trading of different contracts for the delivery of wholesale power boomed in the mid-1990s following deregulation and the inflow of power marketers into the industry.\textsuperscript{92} Trading began with traders buying and selling forward contracts over the phone to energy companies looking to hedge against price volatility and it increased with the development of the internet.\textsuperscript{93} Enron quickly became one of the key players in the wholesale power market, acting mainly as a market maker to which energy was both bought and sold by the firm to make a profit.\textsuperscript{94} Many products sold in this market were conceived by Enron itself and designed to help power

\textsuperscript{87} Id.
\textsuperscript{88} 7 U.S.C.A. § 2(h)(1) (2002). Eligible contract participants are defined in § 1(12) of the CEA; exempt commodities are defined in § 1(14) of the CEA; transactions not executed on a trading facility are defined in § 1(33) of the CEA. In transactions in exempt commodities, the CFTC’s anti-fraud and anti-manipulation rules are retained.
\textsuperscript{90} See S. REP. No. 109–119 (2005) (reporting testimony by industry representatives on the effects of the CFMA on the energy trading markets).
\textsuperscript{91} Growth and Development of the Derivatives Market: Hearing Before the Sen. Comm. on Banking, Housing and Urban Affairs, 109th Cong. (2005) (statement of Dr. James Newsome, Former-Chairman, Commodity Futures Trading Comm’n, President, N.Y. Mercantile Exch., Inc.) (“The futures industry has experienced tremendous growth since the adoption of the CFMA in December 2000, a clear sign that the current regulatory regime is appropriate for these markets at this time.”).
\textsuperscript{92} Neves, supra note 10, at 94–96.
\textsuperscript{93} Id.
\textsuperscript{94} Id.
suppliers manage price risks associated with future electricity purchases.\textsuperscript{95}

By the late 1990s, Enron and other energy traders were hailed as the high-tech future of the power industry.\textsuperscript{96} Among the energy trading companies and in the business community, Enron rose to dominance—becoming the seventh-largest corporation in the United States and the largest energy trader in the world.\textsuperscript{97} For six consecutive years, Fortune magazine ranked Enron as the “most innovative” among the magazines’ “most admired” corporations.\textsuperscript{98} In 2000 and 2001, Enron’s energy trading business was the driving force behind the company’s seemingly unstoppable, yet indiscernible profits.\textsuperscript{99} One description of Enron at this time was “a huge, unregulated trading company—in effect, an investment bank that escaped all the normal prudential and conduct of business rules.”\textsuperscript{100}

Enron was admired on Wall Street as a technological innovator.\textsuperscript{101} Much of Enron’s trading activity took place on EnronOnline, an Internet-based marketplace for buyers and sellers launched in 1999.\textsuperscript{102} EnronOnline quickly became the largest e-business site in the world and the world’s most popular platform for unregulated energy trading, selling nearly 2,100 different products to traders across four continents in fifteen different currencies and averaging 6,000 transactions per day worth about $2.5 billion.\textsuperscript{103} However, in October 2001, after Enron admitted to allegations of overstating profits by more than $580 million since 1997, energy buyers and sellers lost faith in Enron’s creditworthiness and began moving to other marketplaces.\textsuperscript{104}

\textsuperscript{95} Enron was, in essence, two companies. One was an energy supply company that purchased real physical assets such as pipelines and electrical power plants in order to provide energy. The other was a financial institution that functioned as a major dealer in wholesale and derivatives transactions in energy products, other commodities, and some financial derivatives. \textit{See Neves, supra} note 10, at 92–93.


\textsuperscript{97} \textit{MCLEAN \& ELKIND, supra} note 96.

\textsuperscript{98} \textit{Id.}

\textsuperscript{99} \textit{Id.} (recounting the secrecy with which Enron discussed its financial statements and \textit{McLean’s} Fortune magazine article in which she raised questions about the company’s financial statements and reported profits).

\textsuperscript{100} \textit{FT Report, supra} note 63.

\textsuperscript{101} \textit{Id.}


\textsuperscript{103} \textit{Id.} at 4.

\textsuperscript{104} \textit{Id.} at 4.

\textit{Enron} announced huge losses caused by two partnerships on October 16, 2001. \textit{MCLEAN \& ELKIND, supra} note 96.
Enron first caught public attention in 2000 not for its trading platform, but as the leader of a group of companies, many based in Texas, that were profiting hugely as electricity prices soared in California.\(^{105}\) Enron and its peers vigorously denied wrongdoing, noting that price increases were none other than the inevitable result of the state's power shortage. In June 2001, after the Bush administration imposed interstate power price caps that California had sought months earlier, the crisis suddenly eased, and prices in the state plunged. When prices dropped, Enron's profits from California turned to losses.\(^{106}\) Subsequent investigation implicated Enron's energy trading business as a fundamental component of the company's fraudulent accounting and strategy to manipulate California energy prices in the summer of 2001.\(^{107}\)

The functioning of the California energy market created a medium in which price manipulation, and Enron, could flourish.\(^{108}\) Enron was not the only energy company involved in plans to manipulate energy prices in California,\(^{109}\) and it maintained that most, if not all, of its trading strategies were permitted under California's deregulation laws. The goal in California had been a competitive market for the buying and selling of power, but that was not the result. The compromise—deregulation at the wholesale level, but price caps at the retail level—would begin with a utility restructuring law taking effect in 1998.\(^{110}\) Wholesale power prices in California were deregulated, yet power distribution companies were capped as to power costs that could be recovered from ratepayers.\(^{111}\) Enron also gained from a severe drought in the Pacific Northwest, which contributed to power shortages and capped retail prices that provided little if any incentive for consumers to conserve energy.\(^{112}\) Finally, there was little if any incentive to invest in generation assets, which meant there was not enough generation capacity in the state to meet peak day power demands.\(^{113}\) Given the

\(^{105}\) Neves, supra note 10.

\(^{106}\) McLean & Elkind, supra note 96.

\(^{107}\) Internal company memoranda and communications about Enron's practices during the crisis in 2000 and 2001 revealed several schemes designed to exploit Enron's trading position in wholesale energy markets and sustain high prices. See id.

\(^{108}\) Neves, supra note 10, at 101–03.

\(^{109}\) See McLean & Elkind, supra note 96 (noting that at least one generator settled a claim that it withheld power from the California market for the purpose of driving up power prices and making additional profits on its power).


\(^{111}\) Id.


\(^{113}\) Neves, supra note 10, at 101–03. See also Fed. Energy Regulatory Comm'n, The
foregoing, skyrocketing prices and the financial failure of two of the state’s largest public utilities, the shortages in the summer of 2001 should not have been unforeseen.  

IV. THE IMPACT OF ENRON’S COLLAPSE ON ENERGY MARKET REGULATION

In January 2002, one month after Enron filed bankruptcy, the U.S. Senate Committee on Energy and Natural Resource held a hearing soliciting testimony from industry experts and regulators on the impact of Enron’s collapse. The hearing reflected the debates that had dominated the U.S. energy markets since then. Ironically, the then-Chairman of FERC testified at that hearing that “the collapse itself has had little perceptible impact on the commodity wholesale electric and gas markets in the country,” which are the primary responsibility of the FERC. Moreover, the Chairman testified that:

[FERC’s] monitoring of the energy markets to date has indicated there’s been no immediate damage to the energy trading in both gas and electric [sic], or certainly of the underlying physical energy supplies. These energy markets adjusted quite quickly to Enron’s collapse, particularly when you consider that Enron was—counted for 15 to 20 percent of the trades in these aggregated markets. As can be expected, there has been some volatility in these markets with the swift exit of them from trading that has impacted liquidity in the markets, and so the ranges that have traded.

However, the message of that testimony—that the collapse itself was not to blame for the industry’s subsequent problems—was quickly lost as the energy markets declined amidst the subsequent market changes and investigations that contradicted the quick adjustment provided by FERC in January 2002.


114 Neves, supra note 10, at 101–03.


117 Id.

118 See, cf., Energy White Paper, supra note 5; Anne Feltus, Tough Times For Energy Traders, PETROLEUM ECONOMIST, Jan. 13, 2003, 11, 11 (“The fall of Enron has left a trail of devastation in the U.S. energy-trading market, with several other companies struggling to stay afloat.”).
Enron’s collapse prompted several setbacks to the U.S. gas and power trading business. Immediately following the bankruptcy announcement, investors grew anxious that Enron might disappear and quickly sold shares, causing tens of billions of dollars in shareholder value to evaporate. Credit downgrades, falling stock prices, and governmental investigations followed, forcing firms to scale back their trading units or exit the business altogether as $90 billion in industry debt was reduced to “junk” status. By the summer of 2002, the industry “had gone from bad to awful” as regulators, bad publicity, and fleeing investors overwhelmed the “suddenly-sinful” industry. Virtually all of the major energy traders, including veteran energy companies Dynegy, American Electric Power, and Reliant, “capitulated”—selling off or closing energy trading operations. Allegations of fraudulent and illegal trading activity, market manipulation, and other claims levied against Enron and energy traders at over fifty companies, triggered investigations by Congress, the CFTC and FERC. Contrary to initial claims, throughout the energy trading business few companies with gas and power trading operations were spared reputational harm and economic loss, contributing to a loss of confidence in the entire energy trading business.

Enron’s collapse brought an increase in agency investigations and

---

119 See, e.g., MCLEAN & ELKIND, supra note 96 (noting the “flurry” of political uproar and market disasters that followed the Enron bankruptcy and the California Energy Crisis); Energy White Paper, supra note 5.

120 For example, California’s Public Employees’ Retirement System, the largest public pension fund in the country, held roughly 2.8 million Enron shares worth $197 million in 2000. A month after the bankruptcy, on November 29, 2001, the shares were only worth about $1.2 million. Winners and Losers in Enron’s Demise, Fox News (Nov. 29, 2001) [hereinafter Fox News], available at http://www.foxnews.com.

121 Two rating agencies dropped Enron’s credit rating to “junk” status on November 28, 2001. Id.; see also, e.g. Shattuck, supra note 96 (“Several traders, including Dynegy, Mirant, Calpine and Williams, saw their debt ratings downgraded from investment grade to junk status, making it tougher for them to obtain credit to sustain their operations.”).

122 Fox News, supra note 120 (noting that energy companies busied themselves “convincing the world they want nothing to do with the suddenly-sinful business.”). The industry’s financial and structural woes were compounded by increased attention given to Enron and other companies’ financial reporting and accounting, after several high-profile accounting scandals spurred an unprecedented crackdown on corporate crime by prosecutors and regulators. Indeed, in the months immediately following Enron’s bankruptcy, authorities focused their attention on the off-balance-sheet partnerships and accounting techniques that Enron used to inflate its profits.

123 Id. (quoting Mayo Shattuck, president of Constellation Energy Company). These companies had “spent the 1990s reinventing themselves as whizzy energy traders,” only to then retreat from and disavow the business.

124 See, e.g., Energy White Paper, supra note 5.

enforcement actions, as well as political and legislative response. Perhaps the most significant regulatory issue currently facing the energy trading industry is the CFTC Reauthorization. Discussion of the Reauthorization centers on the natural gas market. The following sections describe these developments.

A. Agency Investigations and Enforcement Action

Both the CFTC and FERC conducted investigations in response to allegations that Enron engaged in fraudulent and illegal trading and that it may have leveraged its market position to distort electric and natural gas markets in California and other western states. For the sake of brevity, only the first of FERC’s several energy-market investigations, which resulted in numerous enforcement actions, will be mentioned. In January 2002, FERC initiated a fact-finding investigation in coordination with the Department of Justice (“DOJ”), the SEC, the CFTC, and the Department of Labor to determine “whether any entity . . . had manipulated electric energy or natural gas prices in the West since January 1, 2000.”126 FERC staff released an initial report seven months later, on August 13, 2002, followed by formal enforcement proceedings against three corporate affiliates of Enron and two investor-owned utilities that conducted business with Enron.127 In March 2003, FERC issued its Final Report on Price Manipulation in Western Markets, and moved to strip Enron of its market-based rate authority as a result of conclusions that Enron, as well as other companies, had purposefully, improperly influenced energy prices in Western markets through manipulative and illegal trading practices.128 In addition, the CFTC conducted numerous inquiries of its own into energy trading activities and transactions. Nearly $300 million in fines have resulted from the CFTC’s investigation of about fifty-five companies—with


127 FERC initiated proceeding under section 206 of the FPA regarding possible misconduct by Enron affiliates Enron Power Marketing, Inc., Enron Capital and Trade Resources Corporation, and investor-owned utilities Portland General Avista Corporation and El Paso Electric Company. Id.

twenty-seven companies and twenty-three individuals charged with either false-data reporting or attempted manipulation of the commodities markets.\textsuperscript{129}

Notably, the extensive investigations into all sectors of the energy industry following Enron’s collapse led to increased cooperation among federal regulators and departments in surveillance, investigation and enforcement activities. In October 2005, the CFTC and FERC entered into a Memorandum of Understanding coordinating their oversight activities in energy markets.\textsuperscript{130} The CFTC’s Division of Enforcement investigates and prosecutes individuals and entities for violations of the CEA, including manipulation, false reporting, and trade practice abuses.\textsuperscript{131} These investigations may be conducted in cooperation with the applicable exchanges and other regulators such as FERC.\textsuperscript{132} Also, the Commissions can refer criminal matters involving energy markets to the DOJ for their further investigation (the CFTC has already done so).\textsuperscript{133} This agreement signifies a new approach to oversight of energy markets.

B. Political Response and Legislation

Enron’s collapse provided an impetus for critics of the current regulatory system to lobby for increased regulation across the energy trading industry. Almost immediately, the CFMA’s exemption of energy derivatives from regulatory oversight became a contested issue, as lawmakers questioned whether regulation—of energy trading or of non-bank traders in general—could have prevented Enron’s failure.\textsuperscript{134} Critics attacked the current regulatory scheme and blamed most, if not all, of Enron’s wrongdoings on “huge loopholes” in the CFMA (i.e., the energy exemptions) that had “improperly catered to the interests of Enron and the energy industry.”\textsuperscript{135} Represented primarily by consumer interest groups

---

\textsuperscript{129} Review of the Futures Market and Gasoline Prices: Hearing Before the H. Comm. On Agriculture, 109th Cong. 7 (2006) (statement of Walter L. Lukken, Comm’r, Commodity Futures Trading Comm’n), available at http://agriculture.house.gov/hearings/109/10930.pdf (“Since December 2002, the CFTC has filed thirty-two enforcement actions charging twenty-seven companies and twenty-three individuals for misconduct in the energy markets, resulting in nearly $300 million ... in penalties ... Currently, there are over one dozen open investigations involving the energy markets.”).


\textsuperscript{131} Id.

\textsuperscript{132} Id.

\textsuperscript{133} Id.

\textsuperscript{134} See, e.g., FT Report, supra note 63.

\textsuperscript{135} Senator Dianne Feinstein, Statement on the Feinstein Amendment to H.R. 2673, the FY04 Agriculture Appropriations (Nov. 5, 2003), in 149 Cong Reg. S13961-75 (daily ed. Nov. 5, 2003), available at http://feinstein.senate.gov/03Speeches/derivatives%2011%
and Democratic members of Congress such as Senator Dianne Feinstein of California, they claimed that the CFMA’s regulatory scheme accommodated industry interests and fostered anticompetitive behavior and market manipulation. These critics called for stricter market monitoring, stiffer penalties for market manipulation, limitations on certain types of energy trading, and significant disclosure requirements for contracting parties.

Proponents of increased regulation especially focused on the OTC trading market, which they characterized as a secretive vehicle for traders to manipulate energy markets and defraud regulators and consumers.\(^\text{136}\) In spite of studies by the PWG and other experts,\(^\text{137}\) which concluded the OTC derivatives markets should not be subject to additional regulation, lawmakers and activist political groups supported direct regulation by the CFTC of OTC trading as an urgent necessity to protect consumers and market integrity. This response differed sharply with a depiction of the OTC market found in a federal agency report to Congress in May 2000, which stated, “OTC derivatives have generally been viewed by the federal financial regulators as presenting limited regulatory concerns... because they are considered to be less susceptible to price manipulation... [and present] limited consumer protection concerns because participation is limited to eligible participants acting for their own accounts.”\(^\text{138}\)

As a result of Enron’s abuses, many common trading transactions and strategies were unfairly shrouded in illegitimacy and suspicion.\(^\text{139}\) For example, one strategy Enron used to deliberately manipulate energy prices in California was a trading practice referred to as “round-tripping” in which energy is sold out of an area in the day-ahead markets to be bought back in that area in the real-time market.\(^\text{140}\) Critics, notably Senator Feinstein, characterized such trades as “scam trades,” and proposed a blanket prohibition on the practice.\(^\text{141}\) However, so long as the trade is done within

---

\(^{136}\) See id.

\(^{137}\) See PWG Report, \textit{supra} note 16; see also \textit{UNITED STATES GENERAL ACCOUNTING OFFICE, COMMODITY EXCHANGE ACT: ISSUES RELATED TO THE REGULATION OF ELECTRONIC TRADING SYSTEMS} (2000) [hereinafter GAO Report to Congress on Electronic Trading Regulation].

\(^{138}\) GAO Report to Congress on Electronic Trading Regulation, \textit{supra} note 137, at 10.

\(^{139}\) See Neves, \textit{supra} note 10 at 102–03; \textit{cf.} Feltus, \textit{supra} note 118 (“[Enron]’s successes, it turned out, were based in part on smoke-and-mirrors accounting techniques and bogus trades—common practices in the energy trading sector.”).

\(^{140}\) See \textit{MCLEAN \\& ELKIND, supra} note 96; see also Neves, \textit{supra} note 10, at 103 (noting that the practice is more commonly known as “parking and lending” or “banking” power).

\(^{141}\) Feinstein Statement, \textit{supra} note 135 (noting the bill’s “specific prohibition of the round-trip trading manipulation used so effectively to inflate electricity prices to the public’s injury,” and the “need for explicit prohibitions on harmful and fraudulent market behavior” demonstrated by “the success of the company’s trading strategies”). According to Sen.
the FERC open access transmission rules, the practice is a legitimate "calendar spread" trade that is actually *liquidity enhancing*.\(^1\)

C. The “Feinstein Amendment”

Senator Dianne Feinstein’s energy trading bill, the Energy Policy Act of 2003, was at the forefront of post-Enron attacks on the CFMA and efforts to increase regulation of energy trading. Within months of Enron’s bankruptcy announcement, Senator Feinstein began to push an energy derivatives amendment to the Energy Policy Act of 2003 (the Feinstein Amendment).\(^2\) The bill proposed to increase regulation of OTC trading and impose new disclosure requirements for parties to electricity and natural gas derivatives contracts.\(^3\)

While Enron’s collapse was the most-cited argument for the Feinstein Amendment, other issues motivated bill supporters. Senator Feinstein had raised similar concerns and regulatory proposals prior to Enron’s collapse, during California’s energy crisis in late 2000 and 2001. Additionally, one of Senator Feinstein’s most important allies, the New York Mercantile Exchange (NYMEX), supported the bill as a means of addressing the threat posed by its competitors in the OTC markets. Specifically, NYMEX supported imposing CFTC-style regulations on electronic trading platforms such as the Intercontinental Exchange (“ICE”) and Trade Spark.\(^4\) These electronic trading platforms had quickly filled the void left by EnronOnline

---

\(^1\) Neves, *supra* note 10, at 103 (emphasis in original).

\(^2\) Senator Feinstein has proposed an energy derivative bill, referred to as the “Feinstein Amendment,” on more than one occasion. The Feinstein Amendment was initially proposed in February 2002 as an amendment to S. 517, the initial version of what was eventually enacted as the Energy Policy Act of 2003. The bill was proposed again in the following term in 2003, as an amendment to S. 509, the version of the Energy Policy Act then making its way through the Senate. The Feinstein Amendment required FERC to promulgate regulations establishing an electronic information system to facilitate price transparency and participation in markets subject to the jurisdiction of the Commission; prohibited any person or entity from knowingly entering into any contract or other arrangement to execute a round-trip trade; increased criminal and civil penalties for violations of the Federal Power Act and general penalties of the Natural Gas Act; prohibited manipulation in the wholesale electricity markets and gave FERC discretionary authority to revoke market-based rates for violations; repealed the “Enron” exemption for large traders in energy derivatives and applied the anti-manipulation and anti-fraud provisions of the Commodity Exchange Act to all Over-the-Counter trades in energy derivatives; and provided an exception for financial derivatives and metals. Text of the Feinstein Amendment is available at http://thomas.loc.gov/cgi-bin/query/C?r108:./temp/-rl108S101Q (last visited Apr. 10, 2007).

\(^3\) See Feinstein Statement, *supra* note 135.

\(^4\) These trading platforms qualified as electronic commercial markets under the CFMA. See S. REP. No. 109-119, at 3 (2005) (testimony of ICE President on how the CFMA helped his company).
and continued to flourish as market conditions and innovative products attracted new market participants and revived trading activity among energy companies.\textsuperscript{146}

Nevertheless, if not for the furor and suspicions raised by Enron and the California energy crisis, Feinstein’s proposal would have seemed unlikely, if not illogical, when it was first introduced.\textsuperscript{147} Less than two years earlier, after extensive research, reports, and debate, Congress had passed the CFMA—exempting most energy derivatives and OTC trading from CFTC rules.\textsuperscript{148} In the aftermath of Enron’s collapse, however, the political climate changed significantly and Senator Feinstein’s bill generated media attention and a surprising degree of initial support.\textsuperscript{149}

In response to Feinstein’s proposed legislation, industry participants, including financial firms, banks, energy companies, and industry organizations, quickly opposed Senator Feinstein’s efforts to increase industry regulation and oversight, particularly in the OTC trading markets.\textsuperscript{150} They viewed the proposed regulatory changes as a threat to companies’ ability to “rely on OTC derivatives to manage efficiently the financial market risks inherent in their core economic activities.”\textsuperscript{151} Joined by the Department of the Treasury, the SEC, the CFTC, and the Federal Reserve Board, the industry repeatedly lobbied Congressional leaders to reject Senator Feinstein’s proposals.\textsuperscript{152} Industry leaders warned that

\begin{footnotesize}
\begin{enumerate}
\item[\textsuperscript{147}] Id.
\item[\textsuperscript{148}] Will Acworth, \textit{Traders Up In Arms Over Feinstein Bill}, \textit{Financial Times}, Apr. 11, 2002, at 3, available at http://search.ft.com/ftArticle?id=020411001818 (“The debate in the US Senate over the so-called Feinstein amendment might seem like a sideshow in the great drama of Enron’s rise and fall [when it was proposed in 2002] . . . ”).
\item[\textsuperscript{149}] See id.
\item[\textsuperscript{150}] Letter from the ISDA to the Honorable Bill Frist, U.S. Senate Majority Leader, and the Honorable Tom Daschle, U.S. Senate Democratic Leader (May 7, 2003) [hereinafter ISDA Letter 1], available at http://www.isda.org/speeches/pdf/FeinsteinLetter050703.pdf (“We urge you to oppose any financial derivatives, energy derivatives, metals derivatives and energy trading market provisions contained in S. 509 that may be offered as amendments by Senator Feinstein to H.R. 6, the Energy Policy Act of 2003.”); see also, Acworth, supra note 148.
\item[\textsuperscript{152}] See Letter from the ISDA, to the Honorable Tom Daschle, U.S. Senate Majority Leader, and the Honorable Trent Lott, U.S. Senate Republican Leader (Apr. 8, 2002), available at http://www.isda.org/c_and_a/pdf/Feinstein_Letter-Senate-April08.pdf [hereinafter ISDA Letter 2] (sent on behalf of fifty-three different organizations, including energy companies, commercial and investment banks, financial firms, industry associations, and non-profit organizations). The Letter included a memorandum from the ISDA, \textit{Implications of Feinstein Amendment to S. 517} (Mar. 28, 2002), available at
\end{enumerate}
\end{footnotesize}
enactment of the Amendment would be premature and imprudent given the lack of opportunity for full review of the proposed regulations.\textsuperscript{153} The relevant committees of jurisdiction had not yet reviewed the Amendment’s implications for energy and other derivatives activity.\textsuperscript{154}

Specifically, industry experts argued that the implications of the Feinstein Amendment posed several far-reaching implications that would undermine the legal certainty provided by the CFMA and would be counterproductive to the development of stable, efficient energy markets.\textsuperscript{155} Moreover, the overly-broad Amendment would be detrimental to market participants, engender significant jurisdicctional uncertainty between the CFTC and FERC, and unnecessarily affect transactions and parties outside the scope of the CEA and unrelated to Enron’s alleged malfeasance.\textsuperscript{156} Then-Chairman of the Federal Reserve, Alan Greenspan, and then-Secretary of the Treasury, Paul O’Neil, supported these statements and strongly advised against re-opening the complex regulatory overhaul accomplished in the CFMA.\textsuperscript{157} In contrast to Feinstein’s proposal, which would have created market-undermining uncertainty, Greenspan supported a hands-off approach to allow the market to absorb the Enron shockwaves and respond with innovation.\textsuperscript{158}

The Feinstein Amendment was not enacted in the Energy Policy Act of 2003 as Feinstein had initially hoped. The bill was voted down 56-41 in the Senate on November, 5, 2003,\textsuperscript{159} and industry groups that had lobbied against the bill publicly applauded the Senate’s decision to uphold the

\begin{itemize}
\item \textsuperscript{153} ISDA Letter 2, \textit{supra} note 152.
\item \textsuperscript{154} \textit{Id.}
\item \textsuperscript{155} Memorandum from the ISDA, \textit{supra} note 152.
\item \textsuperscript{156} \textit{Id.}
\item \textsuperscript{157} Acworth, \textit{supra} note 148.
\item \textsuperscript{158} See Herron, \textit{supra} note 146 (noting that the post-Enron online trading markets are more efficient and solid, and that the innovations of bilateral credit risk management and centralized clearing and settlement have enabled online trading to gain ground). While this paper will not specifically discuss developments in online trading platforms, it is significant to note that Herron concludes, “The facility to transact energy trades has not been damaged, and, although there may be some market distortions due to a small loss in price transparency, market efficiency has moved quickly to fill any void.” \textit{Id.} at 144 (emphasis added). See also Alan Greenspan, Remarks by Chairman Alan Greenspan Finance: United States and Global At the Institute of International Finance, New York, New York (via videoconference), Apr. 22, 2002, \textit{available at} http://canberra.usembassy.gov/hyper/2002/0423/epf212.htm (noting that broad deregulation over the past twenty-five years and innovation in financial markets are major factors contributing to the growing resilience of the U.S. economy).
\end{itemize}
existing legal framework. Since then, Senator Feinstein has continued to promote regulations to improve operation of energy markets by introducing substantially similar legislation on three occasions.

D. Market Responses—Change and Resurgence in the Energy Trading Industry

The energy trading market has changed significantly since 2002 due to the emergence of new market participants and increased price volatility. What remained of Enron’s and other energy companies’ trading operations was quietly acquired by a handful of banks and financial institutions. These new players added much-needed market liquidity, but struggled to fill the void left by Enron and other big marketers, such as Aquila and Dynenergy, Inc.

The lack of marketers and reliable counterparties affected the natural gas trading markets, leaving large price disparities between cash and futures markets among regions. Enron and other big marketers had negotiated with an array of parties, from producers to end-users, and were well-placed to take either side of a trade. After their departure, the market lacked reliable counterparties, particularly coast-to-coast marketers. The investment banks that moved into the trading business stepped in on the financial side, offering swaps and options, but were hesitant to get involved in physical delivery transactions or contracts longer than two or three years, a useful tool for manufacturers or power generators looking to hedge long-term fuel costs. According to one futures broker-dealer, the situation as “not only a question of thinning out the number of traders, but the kind of traders that are left.” With fewer traders and a significant decline in gas

---


161 This will be discussed further in the next section, in the context of the CFTC reauthorization.


163 Investment bank UBS Warburg acquired most of Enron’s energy trading operations in February 2002. Barrionuevo, supra note 162.


165 Id.

166 See Neves, supra note 10.

167 Silha, supra note 164 (noting the “obvious” gap in prices and marketing “on the physical side” of natural gas trading markets despite expanded efforts by BP and ChevronTexaco Corp.).

168 Id. (quoting Jan Stuart, vice president of Firmat USA, Inc., a New York-based broker-dealer).
futures trading volume,\textsuperscript{169} liquidity dropped off at many points in smaller markets and in areas away from the major natural gas delivery points.\textsuperscript{170}

More recently, over the last eighteen months, natural gas markets have seen some of the highest prices and largest price swings in decades. During 2006, users complained that shortages of natural gas had created a market dominated by speculators who manipulate prices, and calls to investigate trading practices resurfaced.\textsuperscript{171} Some experts attributed price swings to market changes, such as the new types of traders or less efficient pricing due to fewer buyers and sellers and wider bids.\textsuperscript{172} Other industry experts pointed to factors such as decline in the value of the dollar\textsuperscript{173} and changes in consumption, rather than a lack of efficiency in trading transactions.\textsuperscript{174} At any rate, while unpredictable factors like weather, natural disasters, and geopolitical unrest always have driven the cost of energy, natural gas prices are "especially tricky" and sensitive to weather.\textsuperscript{175}

Natural gas prices are particularly subject to volatility due to particular features of the U.S. natural gas market. Natural gas pipelines have limited capacity and unpredictable factors, such as weather, can affect supply as well as consumer demand. For example, the hurricanes in 2006 exacerbated already low supply levels, particularly in the areas that depend upon the Gulf of Mexico for natural gas, and the unusually hot summer and cold winter drove demand higher than expected, further straining supply. Natural gas can also be transported in liquefied format ("LNG"), but the United States competes with other consuming countries in Europe and Asia, some of which are state-owned and have long-term contracts. Such

\textsuperscript{169} From 2002 to 2003, NYMEX gas futures trade "dropped more than 20 percent from 2002's record volume to just over 19 million contracts." By February 2004, trading volume continued to decline and "open interest, the number of long and short contracts outstanding, [was] down to about 320,000 lots, after peaking at more than 575,000 in April 2002." \textit{Id.} \textsuperscript{170} "The Henry Hub, a key natural gas pipeline interchange in Louisiana, is the standard delivery point for gas futures." \textit{Id.}

\textsuperscript{171} \textit{See, e.g.,} Schroeder, \textit{supra} note 68. The debate over natural gas prices in recent months is discussed further infra Part V.

\textsuperscript{172} Silha, \textit{supra} note 164 (quoting Stephan Smith, head of an energy consulting firm based in Mississippi).

\textsuperscript{173} \textit{Id.} (quoting Joe Terranova, director of trading at MBF Clearing Corp. in New York).


customers are often unwilling to sell gas on the spot market even at very high prices. Thus, supply and demand (and price) of natural gas is uncertain and difficult to predict, making derivatives even more essential to managing risk.

The recent surge in price volatility may have helped to stabilize, or at least revive, not only the natural gas trading markets, but also energy trading in general. Volatility is the feature that both creates risk in energy trading and also makes it so alluring—a correct bet can return “blockbuster” profits, in a short span of time. As such, the volatile energy markets and record-high commodity prices have prompted renewed interest from investors eager to play in the sector, and prices of energy futures “are bouncing around like never before,” multiplying investment opportunities and risks as volatility in other markets has fallen. Capitalizing on the recent market opportunities has allowed investment banks Goldman Sachs Group, Inc. and Morgan Stanley to earn billions of dollars in energy trading in the last two years. In the spring of 2006, Credit Suisse Group and Lehman Brother Holdings Inc., joined by numerous energy-focused hedge funds, followed into the market, rehiring traders away from power utilities and oil-trading firms. In sharp contrast


177 See Davis, supra note 162 (noting that in recent months, “[s]ky-high prices have made energy trading look like easy money,” drawing investment banks and hedge funds back into the business, “reinvigorating some markets that dried up in 2002 after energy-trading behemoth Enron Corp. collapsed.”); see also Barrionuevo, supra note 162 (stating that “[t]he industry that made Enron infamous—energy trading—is springing to life again.”).

178 Davis, supra note 162 (noting, as examples, Amaranth LLC, a $7 billion hedge fund that “made several-hundred million dollars from trading natural-gas futures” last year, contributing to the fund’s approximately 18% return” and Centaurus Energy LP, a $1 billion fund founded by a former Enron trader that “turned a nail-biting December into a blockbuster with a correct bet on natural gas’s downhill slide,” to put the fund up 160% for 2005).

179 Alexei Barrionuevo, supra note 162.


181 Davis, supra note 162.

182 See Barrionuevo, supra note 162 (noting that in Houston, New York and London, competition for “top trading talent has ensued that rivals the cutthroat hiring frenzy of the late 1990s,” and quoting a managing director of a recruiting firm for energy traders as saying, “The whole market is hot right now. . . . Everyone is talking about expansion.”).
to a few years ago, investors began “lining up at the door” to invest in energy trading, in the hope of betting on “the correct side of the whipsaw.” Thus, it appears that market forces have recently begun to revitalize the U.S. natural gas trading markets.

V. PRESENT CONCERNS FACING THE ENERGY TRADING BUSINESS

Industry experts and legal commentators now generally conclude the legal certainty provisions and flexibility enacted in the CFMA are working as intended, in spite of the industry turmoil that followed Enron’s collapse. Nevertheless, the major issues and concerns that grew out of the California deregulation debacle and Enron’s collapse continue to be reflected in current policy debates over energy trading and derivative products. Specifically, vigorous debate surrounds the pending reauthorization of the CFTC. The CEA requires the CFTC to be legislatively reauthorized every five years, to enable Congress to evaluate whether the CFTC’s regulatory structure is accomplishing policy objectives. In practice, various interests recognize the powerful impact the reauthorization legislation can have on the industry and use the process to strengthen or weaken the CFTC and lobby for favorable regulatory changes. Unsurprisingly, in light of the events of 2001 and 2002 recounted above, the new developments and growth in energy derivatives trading markets following the CFMA, and recent volatility and pricing concerns in the energy markets, the 2005 reauthorization legislation is

---

183 Davis, supra note 162.
184 Lukken, supra note 78; Lukken & Overdahl, supra note 18, at § 18:5.4 (“By fixing the once-shaky legal foundation upon which derivatives contracts are based, the CFMA has ensured that . . . [derivatives] instruments will continue to serve an important economic function in our financial system.”). In February 2004, “the notional value of outstanding OTC derivatives contracts [had] grown by almost [fifty] percent” and the CFTC had designated four additional futures exchanges. Id.
185 The current authority of the CFTC officially lapsed on September 30, 2005. Even though the last authorization period lapsed on September 30, 2000, the CFTC was not reauthorized until December 21, 2000, by legislation embedded in the CFMA. While reauthorization is required, there is not much pressure to pass legislation before the charter expires because the agency’s operating budget continues to be funded by Congressional appropriation. The CFTC operated without authorization five times during its thirty-year history, the most recent being September 30, 2000 to December 21, 2000. Lukken, supra note 78, at 1, 3.
187 Lukken, supra note 78.
188 Id.; see also Schroeder, supra note 68. Indeed, the reauthorization legislation can completely overhaul the CFTC’s entire regulatory regime—as Congress did in the last reauthorization, the CFMA, in 2000.
highly contested as well as critical. Current issues in the energy markets influence the reauthorization debates.

As mentioned above, volatility and high prices in natural gas and oil markets, and the recent surge of new speculators entering the OTC trading business has prompted debate over the role speculative trading activity may have played in the recent trend of higher-than-average energy prices. Critics charge that excessive speculative trading in the energy futures and OTC markets buoyed higher prices and volatility in the physical energy markets, particularly in the natural gas market. In 2006, numerous politicians called for investigations into the alleged impacts of "manipulative" energy trading on energy prices. Critics charge that prices do not reflect fundamental market conditions as a result of excessive speculative trading in the energy futures and OTC markets, which is leading to higher prices and volatility in the physical energy markets. According to this theory, trading activity, particularly speculative trading, in the relatively small futures market could leverage enough force to drive prices in the relatively large cash security markets to unreasonable levels.

However, the CFTC has rebuked the charges of market malfunction and the theory on which they were alleged. The commission has been carefully monitoring futures markets for crude oil, unleaded gasoline and natural gas and other energy products and has concluded that the evidence is consistent with the notion that these markets have been properly performing their risk management and price discovery roles. Moreover,

---


191 See generally Brown-Hruska, supra note 174; see also, e.g., Edward Epstein, Oil, Gas Trading Under Suspicion: Feinstein Fears Online Futures Market Ups Prices, SAN FRANCISCO CHRONICLE, May 1, 2006, at A3; Davis, supra note 162 (citing “the surge in investor speculation” as a factor in the recent volatility of energy prices).

192 See, e.g., Epstein, supra note 191 (“Feinstein’s proposal is part of a blizzard of energy-related legislation that members of Congress are pushing, as constituents react angrily to gas prices that have risen to more than $3 a gallon in many parts of the country. . . .”); Cf. Brown-Hruska, supra note 174.


194 Id.

195 Testimony of Walter L. Lukken, Comm’r, U.S. Commodity Futures Trading
in a speech before Washington policy-makers last year, CFTC Commissioner Sharon Brown-Hruska responded:

The idea that a group of speculators can simply enter the market, buy up futures positions, and sustain a long term manipulation of the market, defies logic. For one, futures contracts have a finite life. So whatever long or short position is established, it must be unwound prior to the expiration of the contract. In this case, prices are governed by the law of gravity—what goes up must come down. Secondly, when speculators enter into futures contracts, all they have is a price play. They do not actually have a position in the underlying commodity, so they are not able to tie up inventories, thereby making it unavailable to the market. Thus, their trading does not create shortages that could serve as a mechanism to drive prices up. This can only be accomplished in the physical markets.196

Regulators continue to reject calls for market intervention and additional regulation, rejecting market oversight by stating that speculators in gas futures and derivatives markets cannot manipulate the physical markets.197 The CFTC has maintained that the link between futures markets and commercial activity will assure that futures prices reflect information about the underlying physical market, downplaying the impact of large energy futures positions held by investment banks and hedge funds.198 Other industry insiders also support this position, contending that even aggressive speculative trading activity has affected prices only at the extremes, with the impact mostly exhibited at the market’s peaks and valleys by pushing a trend further than it would have gone otherwise, but even then, only small marginal increases.199 Experts point to specific issues

---

196 Brown-Hruska, supra note 174 (addressing the question of whether the futures markets are “wagging” the physical markets, comparing the current concerns and issues raised to assertions in 1987 that “program trading” in the stock index futures markets led to the fall of stock prices, which was shown to be untrue).


198 Id.; Brown-Hruska, supra note 174; cf. Greg Burns, Why Your Natural Gas Bills Have Soared This Winter; Traders Take Prices On Roller-Coaster Ride, CHI. TRIB., Jan. 15, 2006, at C1 (noting legal and financial experts’ position that even aggressive speculators can help establish accurate prices for natural gas over time by creating excesses in the market) (quoting Prof. Frank Partnoy, University of San Diego Law School, financial markets corruption expert).

199 See Burns, supra note 198 (quoting head of energy products at financial services firm on the impact of speculative traders and hedge funds in natural gas markets).
that affected the recent market swings, including Hurricane Katrina, an early cold snap, and cooler temperatures through the early spring, that turned a previous supply surplus into a squeeze as usage rose and production came under pressure.

Moreover, regulators and other industry experts stated to Congress how natural gas prices have been driven by market fundamentals, not manipulation, when the sharp rise in energy prices and high degree of volatility in heating oil and natural gas futures trading prompted the House Subcommittee on Energy and Air Quality to call for testimony from the CFTC. The Commission presented at that hearing the bases for its view that the high futures prices and price volatility for heating oil and natural gas at that time were indicative of market fundamentals, reflecting expectations of market participants in a time of very tight demand-and-supply balances for these commodities, combined with the impact of the damage caused to the energy infrastructure by the hurricanes.

Certainly, it is precisely during such volatile times when the risk-management and price-discovery features of futures markets are needed most by commercial users of energy products. Both of these functions would be harmed by manipulation of prices—whether by market participants or by regulators. As such, the role of a regulator of a derivatives market is not to influence market prices, but to ensure that the markets are free from fraud or other abuses, and regulators must be careful not to inhibit or interfere with the proper functioning of the futures and OTC trading markets. Thus, the critics’ call for increased regulation of natural gas markets is misguided—Congress and regulators should rely on market mechanisms and the prices signals they emit and not attempt to artificially influence prices.

200 During the 2005 hurricane season, major hurricanes Rita and Katrina “plowed through gas-production rigs in the Gulf of Mexico, raising the specter of severe shortages.” Id. Less than three months later, temperatures plunged across the Midwest and Northeast, where heating demand is greatest. Id. By December 13, prices “that had hovered around $2 million per BTUs years ago” shot up to $15.78. Id.
201 Id. (noting that recent market activity follows a long period of relative inactivity and a supply bubble that had kept prices in check in previous years).
203 Id.
204 The CFTC’s primary mission under the Commodity Exchange Act is to ensure that the commodity futures and options markets operate in an open and competitive manner, free of price distortions. See 7 U.S.C. § 1 (2007).

696
Nonetheless, in the face of record-high gas prices and consumer energy bills, politicians have continued to push for market investigations and additional regulation of OTC oil and natural gas markets, citing concerns of price manipulation. In particular, Democrats have targeted the ICE, the largest OTC trading forum and main competitor of the NYMEX in the energy trading market, because it qualifies as an exempt electronic marketplace under the CFMA and thus, is exempt from direct CFTC regulation. 

Interestingly, observers have noted that the proposed OTC reporting regulations lack studied support. Senator Feinstein’s webpage includes a news article that portray the unregulated OTC derivatives traders as surreptitious schemers who operate free of oversight. While trading parties in the OTC market may not be subject to direct federal regulation, they are subject to various oversight mechanisms. For instance, even though it is an exempt commercial market, ICE is required to comply with the access, reporting and record-keeping requirements of the CFTC. 

ICE participants must qualify as eligible commercial entities as defined by the Commodity Exchange Act, and each participant must report to the CFTC transactional information regarding products that are subject to the CFTC’s jurisdiction and which meet specified trading volume levels. These sophisticated parties, such as banks, may be subject to reporting and other requirement from other regulatory bodies.

A. The CFTC Reauthorization of 2005

Authorization for the Commodity Futures Trading Commission expired on September 30, 2005. The reauthorization will be taken up by the 110th Congress. In previous years, the CFTC reauthorization process has been used by Congress to consider amendments to the CEA, with the last reauthorization resulting in the passage of the Commodity Futures Modernization Act of 2000 (CFMA), the most significant amendment to the


207 Epstein, supra note 191.

208 ICE, supra note 206.

209 Id.

210 See About the CFTC, supra note 79.

CEA since the CFTC was created in 1974. The CFTC reauthorization process began with hearings in the House and Senate in March 2005, at which representatives of the CFTC, exchanges and other futures market representatives, representatives of OTC markets, and other witnesses all testified that, overall, the CEA, as amended by the CFMA, is functioning exceptionally well. The regulators and industry experts agreed that the CFMA has successfully increased innovation and competition in derivatives markets, benefiting customers and the economy as a whole by increasing choices and lowering costs.

The Senate Committee on Agriculture, Nutrition, and Forestry, which was responsible for drafting the CFTC reauthorization legislation, conducted multiple hearings and involved the Senate Banking Committee and the PWG in the drafting process. Throughout the first eight months of the reauthorization process, no significant energy-related concerns were raised, nor were any energy-related provisions included in the Committee’s final version of the bill, S. 1566, which incorporated the PWG’s language and was submitted to the House and Senate Agriculture Committees on November 3, 2005. It was not until then that the first energy provisions were proposed. On December 14, 2005, the House approved H.R. 4473, which incorporated S. 1566 and added a specific provision on natural gas markets.

During the 2006 term, the Senate considered both S. 1566 and H.R. 4473. Consensus language that is relevant to energy trading and contained in both bills includes amending the CEA to increase record-keeping requirements for large traders on the exchanges and to increase civil and criminal penalties for violations. Yet, in spite of the fact that S. 1566
contained no energy-specific provisions, energy-market issues became the roadblock to CFTC reauthorization. Moreover, Senator Feinstein further mired the reauthorization process in the Senate by re-introducing the Feinstein Amendment, which also proposed to extend record-keeping requirements and CFTC oversight authority to exempt derivatives in OTC markets.219 Broadly speaking, supporters argue that these disclosure and surveillance provisions are necessary to prevent and detect manipulation in the natural gas markets and OTC derivatives markets.220 Industry experts maintain, however, that additional regulation is neither necessary nor appropriate and may threaten trading participants’ proprietary information.221 The issues involved in the two provisions are briefly addressed below.

First, the H.R. 4473 natural gas provision charged the CFTC with preventing and detecting manipulation of the natural gas markets, outlined increased record-keeping requirements for large traders operating on the exchanges, and increased the civil and criminal penalties for violations.222 The changes to the CFTC’s current reporting system, the Commitment of Traders Report (COT), would require the system to distinguish among the market participants that currently comprise the category of “commercials,” and require traders to report more detailed information, including contract terms.223 According to supporters, the amendment better ensures the transparency of the natural gas futures markets by clarifying the surveillance and record keeping authorities of the CFTC.224 However, market participants and industry associations adamantly oppose the provision.225 They argue that the proposed changes to the COT system compromise the confidentiality of privately-negotiated contracts and

220 Id.
221 Id.
222 Id.
223 H.R. Res. 4473.
224 See, e.g., Press Release, Congressman Bob Goodlatte, House Passes Commodity Futures Trading Commission Reauthorization (Dec. 14, 2005), available at http://www.house.gov/goodlatte/bobs%20bills%20109/CFTC/CFTC%20House.htm (“I believe this legislation is sound policy that will provide to consumers and end users a high level of confidence that the federal government is watching the natural gas markets and is prepared, if necessary, to take action to enforce the Commodity Exchange Act.”); cf. Brown-Hruska, Houston Speech, supra note 205 (“The bad news, at least as I see it, is that there continue to be efforts to impose more regulation on the futures and [over-the-counter] markets for energy products—veiled in a call for greater transparency in the market.”).
225 See Schroeder, supra note 68.
traders’ proprietary information.\textsuperscript{226} The International Swaps and Derivatives Association, which has successfully lobbied against similar proposals in the past, vowed, “We’ll do whatever we have to do to make sure the natural-gas provision won’t pass.”\textsuperscript{227}

Second, the Feinstein Amendment, which Senator Feinstein has been advocating for nearly five years, proposed to extend the CFTC’s regulatory authority to OTC transactions in exempt derivatives.\textsuperscript{228} The legislation would have authorized the CFTC to monitor exempt-derivative trading transactions on online exchanges much like it does on the futures exchanges and would have required traders on online exchanges to keep trading records for five years and to provide them to the CFTC or DOJ upon demand.\textsuperscript{229}

Like the natural gas amendment, industry groups, regulators, and market experts oppose Senator Feinstein’s efforts to expand the CFTC’s regulatory authority into the OTC markets.\textsuperscript{230} Following Senator Feinstein’s proposal of the amendment in January 2006, CFTC Commissioner Sharon Brown-Hruska responded, reporting to energy trading policy makers and industry leaders, that “The efforts to impose additional requirements on market participants are misguided. Yes, energy prices are high and volatile. But the measures being proposed, some of which have gained favor in Congress, will do little to reign in prices and could actually lead to more volatility in the markets.”\textsuperscript{231}

Led by futures and derivatives trade groups, industry opponents lobbied both Republican and Democrat Senators, CFTC commissioners and staff, and Treasury and Federal Reserve officials.\textsuperscript{232} Industry opponents argued that providing the CFTC with greater oversight authority over the OTC market would cause an exodus of U.S. trading business to less-regulated foreign markets.\textsuperscript{233} Moreover, the Futures Industry Association (FIA), which represents commodity exchanges, futures traders and banks, said the CFTC has neither the authority nor the resources to police and investigate OTC transactions, and that instead, federal prosecutors should be responsible for filing criminal cases against violators.\textsuperscript{234} The CFTC


\textsuperscript{227} Schroeder, \textit{supra} note 68.

\textsuperscript{228} Epstein, \textit{supra} note 191 (discussing he CFTC’s current market surveillance and enforcement procedures).

\textsuperscript{229} \textit{Id.}

\textsuperscript{230} Schroeder, \textit{supra} note 68.

\textsuperscript{231} Brown-Hruska, Houston Speech, \textit{supra} note 205.

\textsuperscript{232} \textit{Id.}

\textsuperscript{233} \textit{Id.}

\textsuperscript{234} \textit{Id.}
publicly agreed with the FIA’s position. Renouncing proposals to extend its authority to OTC commodity markets, CFTC Chairman Reuben Jeffery stated in March 2006 that “the CFTC has no interest, ability or desire to regulate over-the-counter commodities markets” and is not looking to expand its oversight authority into those areas either.235

The dispute over the provisions constrained reauthorization in the Senate. While Senate leaders anticipated holding a floor vote on a version of one of the bills by June 2006, a lack of sufficient agreement to assure passage prevented them from introducing a vote held before the session ended.236 If Congress is deadlocked once again this term, a group of presidential advisers that includes the chiefs of the Federal Reserve Board, Treasury Department, SEC and CFTC, may end up being the final arbiter. In addition to the CFTC’s rejection of additional authority over the OTC markets, the Federal Reserve Board and Treasury Department have raised objections to any such regulation of OTC transactions, based on fears that it could cause legal uncertainty and breed lawsuits that could disrupt the market.237 Moreover, officials from these agencies have opposed similar legislation in the last five years. For example, in September 2002—in the thick of fraud and manipulation investigations—the then-Chairman of the Federal Reserve Board, Secretary of the Treasury, SEC Chairman, and CFTC Chairman expressed “serious concerns” about a legislative proposal to extend CFTC regulation to OTC energy and metals derivatives.238 In their letter to the Senate, the officials objected to disclosure and capital requirements and stated, “We do not believe a public policy case exists to justify this governmental intervention.”239 The officials further warned that the proposed requirements could duplicate or conflict with existing regulations.240 Thus, if these advisers have the final say, it appears likely that the amendments will not pass. However, the ultimate fates of both the natural gas amendment and the Feinstein Amendment remain undecided at this point, as supporters have pledged to reintroduce the substantive provisions this term.

236 Schroeder, supra note 68.
237 Id. (referring to recent letters to members of Congress from these entities).
238 See Greenspan, Others Oppose Expanded OTC Rules, 19 GAS DAILY 182 (Sept. 23, 2002) (opposing a draft amendment to a bill by Senator Feinstein that would have basically overturned the CFMA’s exemption for energy and metals derivatives and require traders to meet certain capital requirements).
239 Id.
240 Id.
B. The PUMP ACT

As the Senate struggled with the CFTC Reauthorization Act, and oil prices set record highs,241 another bill seeking to regulate OTC energy markets, the Prevent Unfair Manipulation of Prices Act of 2006 ("PUMP Act"), was introduced by Congressman Stupak in the House of Representatives at the onset of the new 2007 session.242 The PUMP Act is marketed as a means of establishing transparency in the OTC oil market, which would "require off-market speculators to play by the same rules as speculators who participate in on-market trading already do,"243 and could "reduce the price of crude oil by as much as $20 a barrel."244 Specifically, the PUMP Act would affect OTC trading in more than eight energy markets, including natural gas, by requiring OTC counterparties (currently exempted by the CEA) to provide the CFTC, on demand, with up to five years of books and trading records.245 The PUMP Act would also increase penalties for market manipulation.246 The PUMP Act has been cosponsored by twenty-two other representatives and has been referred to the House Committee on Agriculture.247 As the newly-elected Chairman of the House Energy and Commerce Committee’s Oversight and Investigations Subcommittee, Congressman Stupak has pledged to make energy issues a key focus of his Subcommittee’s work in coming months.

C. Oil and Gas Traders Oversight Act

In April, 2006, Senator Dianne Feinstein introduced the Oil and Gas Traders Oversight Act ("OGTOA") with Senators Olympia Snowe, Carl Levin, and Maria Cantwell.248 Since the Act was not voted on before the close of the legislative session, Senator Feinstein reintroduced the bill in the current legislative session on February 13, 2007.249 The bill seeks to add to

241 Since the beginning of 2005, U.S. retail gasoline prices have been generally increasing, with the average price of regular gasoline rising from $1.78 per gallon on January 3 to as high as $3.07 per gallon on September 5, 2005. See Energy Information Administration, A Primer on Gasoline Prices, http://www.eia.doe.gov/bookshelf/brochures/gasolinepricesprimer/eia1_2005primerM.html (last visited Mar. 28, 2007).
243 Id.
244 Id.
246 See id.
the CEA special recordkeeping and reporting requirements for positions involving energy commodities. The proposed provisions would affect businesses that trade coal, crude oil, gasoline, heating oil, diesel fuel, electricity, propane, and natural gas in the OTC markets, on exempt electronic trading facilities, and on regulated futures exchanges. The bill is supposed to "increase transparency in the energy markets by giving the CFTC the means to effectively exercise its existing anti-fraud and anti-manipulation authority over energy commodities traded on U.S. exchanges." Similar to Senator Feinstein's proposed natural gas amendment to the CFTC reauthorization Act of 2005, OGTOA would mandate the CFTC adopt a rule that any person holding, maintaining or controlling any position in any certain contracts must maintain such records as directed by the CFTC, and to be produced on demand to the CFTC or the Department of Justice, for a period of five years or longer. Additionally, the CFTC would be required to adopt a system for requiring the regular or continuous reporting of positions in certain contracts. Despite support from numerous co-sponsors, the bill never went to a vote before the 2006 session ended.

Industry groups and leaders that oppose the OGTOA maintain that the reporting requirements are not only unnecessary, in light of existing CEA provisions, but also potentially detrimental to the industry, in that the costs of implementation and compliance would outweigh the Act's potential benefits. These critics note that the CFTC has demonstrated that it has adequate authority and the ability to police the false reporting and attempted manipulation of energy prices, under CEA. They also note the CFTC's collection of fines over the past five years in excess of $300 million.

D. Recent Industry Response to Calls for Additional Natural Gas Legislation

In February 2006, FERC Commissioner Nora Brownell testified before

In her testimony, Brownell emphasized market fundamentals to explain the high prices and volatility, including inadequate infrastructure, depletions and disruptions in natural gas supply over the past few years, and the inextricable link between electric prices (which are most perceptible to consumers) and the natural gas market.\footnote{Id.} Brownell rebuked the temptation to politicize the debate on high energy prices, stating that “unfortunately, we all too often find it more comfortable to blame the high energy prices on unprecedented natural catastrophes, market manipulation, or revelations of corporate malfeasance instead of addressing the underlying economic issues.”\footnote{Id. at 3.} It appears that the industry and regulators may have also exercised the contention that the CFTC has adequate authority and tools to oversee the OTC markets and monitor natural gas markets to prevent price manipulation. In November 2006, the Intercontinental Exchange, (ICE), the leading global, electronic marketplace for trading both futures and OTC energy contracts, announced it began reporting to the CFTC.\footnote{See ICE, ICE Statement on Reporting to the CFTC (Jan. 19, 2007), https://www.theice.com/showpr.jhtml?id=5066.} The CFTC exercised its authority under the CFM to request that the exchange begin submitting trading reports for certain markets, including natural gas contracts.

VI. CONCLUSION

Enron’s collapse and the crisis in the California wholesale power markets severely weakened the developing wholesale and retail electricity markets. Yet those experiences underscored the more critical risk to the viability of the development of competitive wholesale and retail power markets in the United States—regulatory uncertainty caused by inconsistent legal standards governing energy trading practices. Clear trading rules are a critical component to an efficient commodity market. However, proposed regulatory requirements would disrupt the legal certainty achieved by the CFMA that is fundamental to the growth and stability of all derivatives trading markets.\footnote{Kramer, Pantano, & Ezickson, supra note 18, at 107.} Moreover, when evaluating regulatory concerns, it is important to consider Enron’s truly unique role in the energy trading markets. Enron was fortuitously positioned in the rise of the energy trading industry by a combination of its own innovation and strategy and favorable
Beyond Enron

legislative and market conditions, such that at the height of its success, Enron dominated as both a provider and consumer of trading products and services. Yet Enron went to great lengths to ensure that its trading continued to escape regulation—one reason why it was such a heavy contributor to political campaigns. Enron confined itself to unregulated markets and was not classified as a bank, insurer or fund manager, shrewdly positioning the company to achieve something unavailable to any other leading dealer in derivatives contracts—complete exemption of its activities from federal supervision and oversight.

Nevertheless, Enron’s exceptional position was not only unprecedented, but also unlikely to be duplicated. Certainly, the post-CFMA growth of the OTC derivatives markets has resulted in many financial businesses transacting on a large scale in those trading markets, which are free from exchange and CFTC regulation. However, after Enron’s departure the energy trading industry restructured and is now dominated by investment banks, insurance companies and other regulated entities that transact on independent trading platforms. Unlike Enron, these entities, as deposit-taking institutions, insurance companies or fund managers, are supervised under one or more federal regulatory schemes. This provides oversight and disclosure of these companies’ financial viability, mitigating many of the concerns involved in Enron’s startling collapse. Moreover, the futures and OTC markets are necessarily interdependent and as such, even entities such as hedge funds that do not fall within banking, insurance or financial intermediary regulations, can still find that aspects of their OTC trading activities are subject to oversight.

---

264 Neves, supra note 10.
265 See William W. Bratton, Enron and the Dark Side of Shareholder Value, 76 Tul. L. Rev. 1275, 1279–80 (2002) (stating that Enron spent copiously on politics and “obtained good results from such investments.” Senator Phil Gramm, the spouse of one of Enron’s directors, “assured that the [CFMA] included the ‘Enron Point,’ a complete exclusion for energy trading companies from capital or disclosure requirements respecting portfolios of over-the-counter derivatives securities [sic],” thereby “achieving something available to no other leading dealer in derivatives contracts—complete exemption of its activities from federal supervision and oversight.”).
266 Id.
267 See Neves, supra note 10.
268 See, e.g., Davis, supra note 162.
269 Cf. Bratton, supra note 265; Energy White Paper, supra note 5 (highlighting the importance of being able to evaluate and manage credit risk among trading parties).
270 See Brown-Hruska, supra note 174 (noting the interdependency and linked functions of futures and over-the-counter markets).
271 As an example, hedge funds are essentially fund managers that have too few investors to fall into the regulatory net, but when they transact business on regulated exchanges—buying and selling futures, for example—their trades pass through regulated brokers. That brings much of their activities, if not the funds themselves, within the scope of regulation.
Finally, the development and regulation of clearing systems for OTC trading platforms has dramatically mitigated credit risk and enhanced stability of OTC trading, facilitating the CFTC’s fundamental objectives more efficiently than externally-imposed regulation.\(^2\)

In sum, Enron’s collapse created high sensitivity to the notion of market abuse and brought heightened scrutiny to energy deregulation, energy derivatives, and credit issues within the market. This skepticism resulted in a fundamental loss of confidence in the energy trading industry and regulation.\(^2\) While the industry has made progress, that distrust and loss of confidence has not been completely overcome and continues to influence current industry issues and regulatory debates. However, the regulatory scheme enacted in the CFMA has succeeded in facilitating innovation and competition across the energy derivatives industry, enabling the market to emerge from the post-Enron downturn more efficient and solid than before.\(^2\)

FT Report, supra note 63.

\(^2\) Cf. S. Rep. No. 109-119, supra note 145 (testimony of ICE President on how the CFMA helped his company); Herron, supra note 146 (describing how the online trading markets have innovated and emerged stronger and with more safeguards against industry risks and manipulation). The ICE, which has now emerged as the largest OTC energy derivatives market, offers clearing, oversight and other safeguards for market participants.

\(^2\) See Kramer, Pantano & Ezickson, supra note 18, at 106–09. Rapid growth, inadequate credit and risk management controls, a poorly designed California energy market and the Enron bankruptcy all contributed to this loss of confidence in energy trading markets. See Energy White Paper, supra note 5.

\(^2\) Cf. Herron, supra note 146, at 143; Elizabeth Rigby, CFTC Chief Ready For Change. FIN. TIMES (Apr. 5, 2004), available at 2004 WLNR 9715584 (describing the U.S. futures industry as “more competitive now than ever before,” as a result of the CFMA’s impact on over-the-counter derivatives and competition from European futures exchanges).